HELP ?

Reprivatizing Russia

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Abstract:
It is argued that privatization has failed in Russia. If Russia and its Western advisers acknowledged this, they might together be able to fashion a more workable transition to a market economy. The privatization plan designers - both the Russians and their Western advisers - refuse to admit that their blueprint for privatization was a dreadful mistake, not recognizing that Russia and Russians are a world unto themselves. It is suggested that privatization cases that involved illegal procedures should be reexamined and renationalized, then offered again for sale later.

Full Text:

[Headnote]

Privatization failed in Russia, this economist argues. If Russia and its Western advisers acknowledged this, they might together be able to fashion a more workable transition to a market economy.

EVALUATING the privatization process in Russia with the aid of hindsight is, of course, easier than designing a program ex ante. Nonetheless, the plan designersboth the Russians involved, such as Anatoli Chubais and Maxim Boycko, as well as Western advisers, particularly Andrei Shleifer and Robert Vishny-refused to acknowledge that their blueprint for privatization in Russia was a dreadful mistake, a consequence of their failure to recognize that Russia and Russians were a world unto themselves. Not appreciating initially how misguided their privatization campaign had been, the latter three-Boycko, Shleifer, and Vishny-have even claimed credit for what they thought was the success of their plan. To compound their error, they insist in their 1995 book, Privatizing Russia, that the privatization process in Russia would not have evolved "if fundamental economic principles were not deemed as workable in Russia as elsewhere in the world."1 Even more to the point, "Perhaps the one view that the Russian privatizers shared most strongly was that the Russian people, like the rest of the world, were 'economic men,' who rationally responded to incentives."2 They have no patience for "sovietologists" who, as they put it, "shared the idea that the Russian people, by their very nature, are incapable of responding to incentives."3

Today, as they survey the dysfunctional mess created in the wake of their misconceived efforts, I daresay they may have some second thoughts. Certainly, other non-sovietological economists, among them Alan Greenspan, chairman of the Board of Governors of the Federal Reserve Bank System, have come to warn against mistaken assumptions that Russians respond like their counterparts in the West.4 Joseph Stiglitz, until January 2000 the chief economist of the World Bank, is another critic of the Chubais, Boycko, Shleifer, and Vishny view In turn, he has borne considerable criticism for the outspoken nature of his attack on the International Monetary Fund and the so-called "Washington consensus," which has been shaped in part by ideas put forward by the Boycko-Shleifer-Vishny trio.5

Stiglitz has criticized in particular "the West's best and brightest," who ended up relying on what he calls "simple textbook models or naive ideology." Evidently feeling himself caught in the act, Anders Aslund, the author of the now mistitled How Russia Became a Market Economy, responded that "Stiglitz [he leaves out Alan Greenspan] is a striking embarrassment to himself and the World Bank. Without knowing anything, he mouths any stupidity that comes to his head."6 It is not so much that Russians always react differently to incentives (although after seventy years of authoritarian Soviet mental conditioning, some still do), but that the ill-formed market infrastructure within which those incentives operate is all but guaranteed to produce differing results. To provide a better understanding of the challenge involved in designing a privatization program in Russia, this article will specify just what a successful privatization program should accomplish and then outline what, if anything, can be done now to correct the damage and to set in motion such a program.

Desirable Factors of Privatization

There are many desiderata of a successful privatization process, not all of which are compatible. Among the most important, the reform should seek to ensure that the privatization effort:

is carried out in a theft-free environment. As a minimum, it should not lead to an increase in corruption and theft.

does not benefit any group unduly, and that the state and public at large also share in the process, both at the time of privatization and thereafter.

results in increased efficiency by bringing in new management if necessary and restructuring or even closing down inefficient divisions.

ensures that the factory directors in the old regime, if they are capable, stay on and do not become the effective owners once the enterprise is privatized. This often happens, especially if the newly issued stock is too widely dispersed.

encourages investors, including foreigners, to invest in these new companies or in competing entities.

does nothing to detract from the even higher priority of encouraging startups in greenfield businesses.

furthers the development of a market infrastructure.

contributes to the strengthening of democracy.

Effective Implementation

Establishing what should be done is the easy part of the assignment. Implementing those goals is what separates the hindsighters from the heroes. In some countries, an elaborate set of decrees has been drawn up and adopted and whole legal codes have been plagiarized intact from older, long successful privatization experiments. All too often, however, when such adoptions have been attempted, nothing much more happens. The transplant does not take. Given the differences in culture, history, and previous economic and political evolution, the systems prove to be incompatible. Just because an economic process works in the United States or the United Kingdom is no guarantee that it will work in a country that has been subjected to forty-five or seventy years of communism. Given the differences in mores and institutions, the results, if anything, are bound to be very different. To be successful, the adoption of foreign experiments and legal codes must be designed so that those affected find it in their self-interest to support such rules. In this way, the new owners become self-enforcers. It is rare that farreaching measures of this sort become successful if the rules of the game are imposed only from the top down. The trick, then, is to design a system that will generate self-interest.

An analogy to traffic lights might be useful. Normally, most of us deplore the installation of a new traffic light on our drive to work. It is likely to slow us down. Yet, there clearly are occasions when not only the immediate neighbors but passersby as well welcome the new intrusion. They find that, in the face of an increased number of cars and resulting gridlock, such a light not only makes for increased safety for the neighbors, but it may actually speed the flow of traffic. Similarly, when the number of operating businesses reaches a certain level, there is more likely to be support for regulation and restraints, because the majority of businesses perceive that they will be more profitable in such a regulated arena than without such regulations. To reach such a desirable state, however, steps must be taken to build up that business and legal infrastructure by encouraging new business start-ups and the privatization of small state business entities. Only when that competitive infrastructure has been established should an effort be made to privatize larger state enterprises or monopolies. The Chubais, Boycko, Shleifer, Vishny school seemed to ignore the fact that when you privatize a state monopoly, you almost always end up with a private monopoly that operates little differently from its antecedent. No wonder so many of the newly privatized enterprises in Russia behave much the same as they did in the Soviet era and disregard the operating customs that are considered to be so sacrosanct in the West. That is why it is so essential to concentrate on the creation of a competitive market infrastructure with a multitude of players who will support and maybe even enforce the rules of the game that are considered to be the hallmark of a market economy.

To give them their due, Chubais et al. did understand the importance of bottom-up support. Chubais has made very explicit his fear at the time that unless he could create a popular base of support among the public at large, the communist nomenklatura in 1992 might well have succeeded in bringing back the communist system. For that political reason, he moved rapidly to issue vouchers to every Russian citizen. This "people's capitalism," he has explained, would have created stakeholders among the public at large. Co-opted with their share of ownership in the Russian private sector, the public would then fight to sustain private ownership.7 What he neglected, however, was that those 150 million vouchers resulted in a form of ownership that was too diffuse and thus ineffective in inducing market-type behavior on the part of the factory director. Instead, more often than not, the factory directors quickly came to see that they could end up as the de facto owners of their factories and then proceed to strip the assets as they pleased. Rather than move so quickly to privatization through voucher issuance, Russian reformers would have been much better advised to focus on fostering start-ups and the building anew of a market and the accompanying infrastructure with its transparency, rules of the road, accountants, lawyers, and commercial codes.

Examples of Effective Transition

To highlight why the Russian experiment was doomed to failure, it might be useful to examine some case studies where privatization of state enterprises was considerably more successful. First examining what might be considered the ideal climate for privatization will dramatize how ill-suited Russia was at the time to embark on the process. Even though the Labor Party in England had nationalized several of the United Kingdom's larger industries, the underlying economy was dominated by markets, private economic activity, and a very sophisticated banking and finance infrastructure. Under the circumstances, beginning in 1979, the conservative government under Margaret Thatcher found it relatively easy to sell shares in state-held industries. These public offerings were spread over a period of several years, allowing the market time to digest the transfer of more than $134 billion. It also helped enormously that England already had in place one of the most sophisticated financial systems in the world, with investment and commercial bankers, stock markets, and commercial codes and laws that were adhered to but enforced if necessary. The privatization effort eventually encompassed such entities as Cable and Wireless, British Petroleum, British Telecommunications (BT), British Steel, British Airways, British Gas, and several of the electric and even water utilities. Relying entirely on market stimuli and without the issuance of vouchers, the number of individual British shareholders more than doubled from 4 million to almost 10 million from 1983 to 1995.8 British privatization was far from perfect, and there were recurring complaints about insider profiteering and overly generous golden parachutes. Still, during the preparation for privatization and thereafter, there was general agreement that the process resulted in increased efficiency, a smaller workforce, and increased competition among the now private businesses.

While its market was not nearly as entrenched or pervasive, Poland also implemented a relatively successful transition to the market, including a privatization effort. In fact, in comparison with what happened in Russia, Ukraine, Belarus, and even the Czech Republic, Poland's effort stands as a model of how to do it. Nonetheless, given that switching to a market economy invariably creates winners and losers, the transition was far from flawless. Adopting the basic tenets of what came to be called the "shock therapy" approach, there were serious problems in the first two years or so. Not only did everyone not benefit equally; there are serious concerns about the degree of present-day corruption (although very few complaints extend to the privatization process). Reflecting that discontent, the Poles voted back in a communist government and a communist-backed president.

Yet the Polish reforms, as imperfect as they were, paved the way for a quite remarkable escape from the grip of central planning. As proof, between 1989 and 1998, Poland had the fastest rate of growth in Eastern Europe. According to estimates of the European Bank for Reconstruction and Development, Poland's gross national product (GNP) in 1998 was 117 percent over what it had been in 1989. Except for the Slovak Republic in 1998, every other member of the Warsaw Pact or the former Soviet Union republic had a GNP lower than it had been in the communist era 9 Indeed, until recently, Poland had the highest rate of growth in all of Europe.

It would make for a fairy tale ending if we could claim that all this came about because the Poles adhered to a specified game plan. There was indeed a plan and they did implement large chunks of it, but, fortunately for Poland, they could not agree on their privatization strategy. As a consequence, they delayed the privatization of most of their larger enterprises until about 1995. However, they wisely moved ahead with their plan to facilitate the start-up of new businesses, supplemented with the privatization of small state shops and services.

The Poles did not appreciate at the time how lucky they were. The delay gave them time to learn from the mistakes of others who had moved too impetuously. In the interim, the Poles could design a program that would spare them from making similar mistakes. Janusz Lewandowski, the architect of the Polish privatization program, had several clear priorities.10

Polish factory managers should not be allowed to gain direct or indirect control or ownership of their factories.

Factories must be not only privatized but restructured so that they are better able to compete, not only in Poland but also externally.

While Polish citizens and the Polish government would continue to own these factory assets, it is essential to design a mechanism that takes into consideration the advice of foreign specialists and advisers when investment and business strategy decisions are made.

The public at large, not just the factory managers and workforce, should benefit from both the process of privatization and the subsequent and ongoing operation of these enterprises.

The process should be transparent and corruption-free.

By the time the Poles were ready to implement such an ambitious program, their ongoing emphasis on the formation of startup businesses had created for them a workable market infrastructure. Not surprisingly, it was not fully formed, but there was enough of it in place that by the time the state enterprises had been privatized, these now-private entities found a relatively competitive environment that they could not dominate.

Russia's Impediments: Blind Spots and Voids

The Russians were not nearly as fortunate. Following Poland's example, they too decided upon a "shock therapy" type of program. But disregarding warnings from some veteran sovietologists, the reformers, as noted earlier, refused to acknowledge that Russia was a special case. It was inconceivable to them that an economy could exist without an underlying market infrastructure. Just as when "shock therapy" reform was introduced in developing countries, the reformers in Russia assumed that all it would take would be a dose of fresh economic air to turn what was a dysfunctional economy in extensio into a functioning one. With a freely functioning price system, prices would rise, queues would shrink, profits would rise, and output would increase. Almost immediately, new businesses would open their doors and a viable market infrastructure would take form. As in the fairy tale, once the princess kissed the sleeping prince, he would awake and everyone would be gainfully employed ever after. The problem, however, was that the prince (the competitive market in Russia) was not asleep, he was dead. Even Monica Lewinsky would not have been able to arouse him.

By now even many of the early optimists have come to recognize why they were foolish (they would probably prefer to say "overly optimistic") to expect a market would spring to life so quickly in post-communist Russia. If for no other reason, Russian authorities, out of ideological restraints, have always attached a low priority to making service and retail trade available to the public. As a result, the USSR had one of the lowest store-- to-consumer ratios in the developed world. Thus privatization alone of small stores and restaurants, even if carried out quickly and smoothly, would not have resulted in a highly competitive climate.

At the time, few reformers in or out of the government seemed to appreciate how radical a transformation from central planning to the market would have to be. Nowhere was it easy, but it was particularly difficult in the Soviet Union where, except for the Baltic States, communism had been in place an extra twenty-five years and instituted from within, not imposed from outside. This meant that fewer echoes or remnants of the market had survived. In fact, in the case of Russia, there were almost no institutions available to take over once Gosplan, Gossnab, and the various economic ministries were abolished. That meant that not only was the retail and wholesale network of stores and warehouses woefully inadequate, there were no operating codes, accounting practices, bankruptcy procedures, and commercial banking requirements to guide business decision-makers. That described the anarchic nature of the commercial and industrial sector. To be successful, however, there also has to be a supportive and reasonably corruption-free government support apparatus accustomed to dealing with private business operations. That, too, was lacking.

Even now the enormity of that void escapes most analysts. Factory managers suddenly found themselves without a guide as to where to find inputs and how much to pay for them and, similarly, what to do with their outputs and how much to charge for them. At the same time, while government officials had been divested of their former responsibilities and obligations, they were as yet unfamiliar with the new powers normally operative in market economies. To make matters worse, Russia at the time was caught in a hyperinflationary environment, as evidenced by the twenty-six-fold price increase that occurred in 1992. Since government salaries did not keep pace, it was inevitable that government officials en masse would seek to make up the difference with all but unparalleled corruption and extortion. As a result, Russia today finds itself near the bottom of almost every survey of honesty in government.11 So it should come as no surprise to learn that increasing the number of tax inspectors leads to a drop in per capita tax collection. The money otherwise destined for the government is diverted instead to the tax collectors' pockets.12

Inevitably, this affected the transformation process and the ability of businessmen to open, operate, and grow a business. Reflecting the contrast between the successful transition in Poland and the unsuccessful effort in Russia, Timothy Frye and Andrei Shleifer found that 8.99 percent of the businessmen they surveyed in Warsaw reported that they had been inspected in the past year, compared to 18.56 percent of Muscovites.13 Even more striking, 76 percent of the Muscovites acknowledged that they could not operate without "an umbrella" or "mafia roof," whereas only 6 percent of those in Warsaw felt a similar need.

The market environment that has evolved in Russia therefore is a hybrid that few in the developed world would recognize. That is not to deny that there is corruption or crime elsewhere in the world. But the extreme nature of the distortion makes for qualitative differences. It would not be an exaggeration to say that the experiment in Russia has resulted in a Frankenstein-- type market, not the kind that evolved in Poland and that we Western economists had hoped for in Russia.

Is There Any Remedy?

The challenge now is to see if the damage that has been done can be remedied. Normally social scientists tend to argue that anything can be corrected if there is enough ingenuity, effort, patience, and material support. Russia, however, may be the exception, unless patience means waiting for three to four generations.

Retrofitting is always more difficult than doing something properly the first time around. Not only have many Russians lost faith by now in the transition process itself, but those few oligarchs who have benefited so enormously have acquired a vested interest in the status quo, whether it is good or bad for the country as a whole. What should the strategy be now?

Based on the argument presented earlier, the reforms will be successful only when there is pressure from the public at large and the business community, not only for a set of more equitable laws but for the enforcement of those laws, both from above and below This means multiplying the number of businesses and service providers at all levels. If this can be done, it will lead to the weakening of the oligarchs and monopolists and also make it harder for the Russian mafia to maintain its control. Just as the repeal of Prohibition in the United States reduced the sway of the American Mafia (with the legalization of the sale of alcohol and the increase in the number of legal bars and package stores, the Mafia had a much more difficult time controlling and taxing the sudden influx of new legal outlets), so a tripling or quadrupling of outlets is likely to overtax not only the mafia but corrupt bureaucrats as well. Moreover, a larger number of business men and women is likely to mean that there will be more effective lobbying groups, interested and determined to set restraints on the bureaucrats' ability to abuse the property rights of others.

To accomplish this, someone will have to undo the damage done by Moscow's mayor, Yuri Luzhkov, who on May 2, 1992, countermanded Boris Yeltsin's January 29,1992, decree that anyone anywhere could sell whatever they wanted to.14 This aborted what might have been the best chance Russia had to build up the marketing infrastructure that it lacked. In that four-month period, Russians from across the country flocked to major intersections and metro stops to sell whatever they could assemble. Many were selling out of desperation, but similar sidewalk markets had served as the start-up incubator for businesses in China and Poland. If Chinese and Polish leaders had insisted, as did Victor Chernomyrdin, the newly installed prime minister, on December 16, 1992, that Russia would not be a "bazaar," then China and Poland too might never have developed the marketing and eventually manufacturing infrastructure that now serves them so well. To both Luzhkov and Chernomyrdin, the sight of these rather disheveled hordes was not a pretty or a prestigious one, but that is how so many successful business leaders have begun. Reportedly, Luzhkov was also responding to pressure from several of the city's Mafia groups, who found themselves unable to corral and organize such a large number of vendors.

The challenge now is to reverse the policies of the past and revitalize those who earlier attempted to start up businesses. Such a reversal means eliminating the regulations and permits that serve as restraints and inhibitors. This action will require abolishing the prerogatives of the local and regional bureaucrats, even firing many of them from their lucrative posts. Given the traditional role of the Russian chinovnik that dates back to the early czarist times, getting rid of these bureaucrats will not be easy. A modern-day parable is the decision of the mayor of Mexico City to allow only female police officers to issue traffic tickets. This move provoked a strike from the male police, who had come to rely on bribes from traffic offenders to more than double their income.15

Eliminating bureaucratic obstructions and corruption is one part of the process. Once the doors have been opened, an attempt must also be made to facilitate start-ups by offering readily available loans, something that Russian banks heretofore have tended to avoid. The European Bank for Reconstruction and Development has set up a small-loan-fund facility. Some U.S. foreign aid is also being used for this purpose. Such start-up funds are an ideal project for a foreign-aid provider as well as private investors. The result could be something on the order of the "microbanks" that have succeeded so well on the south side of Chicago. Once more foreign lenders become engaged, it is likely that both Russian banks and state and local agencies will also become more active. There is no good reason, for example, why there should be upward of 2 million registered small businesses in Poland today compared to only 890,000 in Russia.16

As fraught with danger as it might be, something also must be done to redress some of the privatization abuses of the past. A study by the Russian Duma Committee on Privatization has reported that, from 1992 to 1996, the government collected only $20 billion from the sale of about 70 percent of what had been the nation's state enterprises. According to their study, "too much was sold off, and often at the wrong time,"17 under a set of laws that "covered only about 15 percent of the legal issues involved."

Even though it means taking a leaf out of the handbook of the Communist Party of the Russian Federation, privatization cases that involved illegal procedures should be reexamined and, where appropriate, the enterprise renationalized. Owners should be compensated or given the right of first refusal to make up the difference between the market value at the time and what they actually paid. Those businesses acquired as part of the Loan for Shares program, in which valuable properties were sold at onetenth their value to oligarch insiders in rigged auctions, should be made special targets. In addition, enterprises should also be renationalized when the management is unable to pay the bills, including invoices, salaries, and taxes. In all cases, of course, those renationalized properties should be reoffered for sale.

Renationalizing property this way and then offering it again for sale is an easy target for abuse. The effort to restore credibility to the process would be undercut if the renationalized effort were viewed as vindictive retaliation by one clan or party against another. More than that, no one should be allowed to warp the bidding process with terms so narrow that only one bidder qualifies. Equally troublesome, a determination must be made whether to allow foreigners to bid. The winning bids will be much higher and the state and the public will share more in the proceeds if foreigners are included, but this may well feed the fear of those who worry about foreign dominance of Russian industry. Perhaps foreigners can be included, but only as junior partners in the bidding process. Given the way minority shareholders have been treated in the past, many foreigners may hold back, but at least such an attempt should be made.

Conclusions

If markets in Russia are to operate in a meaningful way, not only must there be an effort to make it easier for potential entrepreneurs to exercise their talents, but also something should be done to actively facilitate, even stimulate, their efforts. At the same time, past abuses must be redressed. All of this means that crime, unfair business intimidation, and corruption must be curbed.

Easy to say, hard to do. But only when the number of businesses has multiplied will there be grass-roots and vested-interest pressure to restrain crime and abuses of government power. Without pressure from the business community to impose such restraints, meaningful reforms may never take effect.

[Footnote]

Notes

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1. Maxim Boycko, Andrei Shleifer, and Robert Vishny, Privatizing Russia (Cambridge: MIT Press,1995), vii.
2. Ibid., 9.
3. Ibid., 10. See note 2 and the reference to Marshall I. Goldman, Lost Opportunity: Why Economic Reforms in Russia Have Not Worked (New York: Norton,1994),18.
4. Alan Greenspan, "Remarks to Woodrow Wilson Award Dinner" (Woodrow Wilson International Center for Scholars, New York, June 10,1997), 5.
5. Newsweek special issue (December 1999): 58.
6. Economist, September 18,1999, 81; Anders Aslund, How Russia Became a Market Economy (Washington, DC: Brookings Institution,1995).
7. Author interview with Anatoli Chubais, St. Petersburg region, June 27,1993.
8. Financial Times, January 17,1997, 17.
9. "EBRD Transition Report,1999," Financial Times, November 10,1999, 2.
10. This is explained in greater detail in Marshall I. Goldman, "Privatization Property Rights and Development Potential," Eastern Economic Review 25, no. 4 (fall 1999): 389.
11. Financial Times, December 14,1999, 1; Transactions 10, no. 5 (October 1999):1.
12. Manoucher Mokhtari and Irina Grafova, "The Russian Federation at Crossroads: Tax Collection, Transfers, and Corruption"(University of Maryland, November 1999).
13. Timothy Frye and Andrei Shleifer, "The Invisible Hand and the Grabbing Hand," American Economic Review (May 1997): 356.
14. Rossiiskaia gazeta, February 1, 1992, 2; February 4, 1992, 1; New York Times, May 13,1993, A4.
15. New York Times, August 15, 1999, sec. 4, p. 3.
16. Ekonomika i zhizn, no. 43 (October 1999): 28.
17. Moscow Times, December 2,1999.

[Footnote]

[Author note]

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